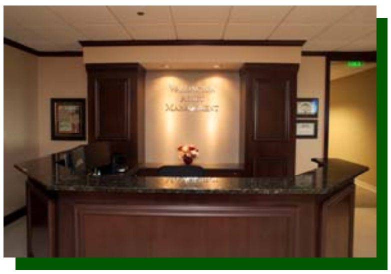
Wallington Asset Management — Independent Investment Counsel — 25 Years — 1988–2013

QUARTERLY REVIEW

2013: FOURTH QUARTER

100TH EDITION



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COMMENTARY

2014: EXPECTATIONS HIGHER FROM ONE YEAR AGO

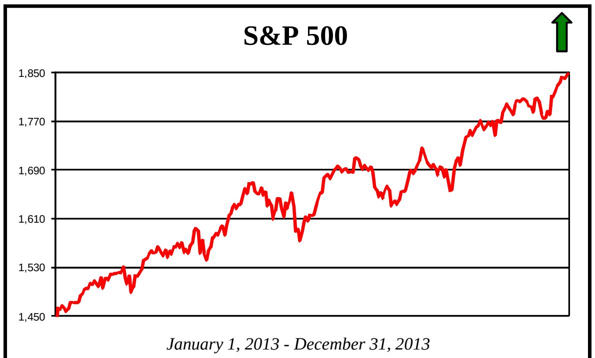
Last year, 2013, provided a lot for which to be thankful, contrary to the beliefs of many when it began. The year was ushered in by fears surrounding the fiscal cliff. In late December 2012, Pierre Ellis, economist with Decision Economics, opined that the just-released December consumer confidence report, "is obvious confirmation that a sudden and serious deterioration in hopes for the future took place in December – presumably reflecting concern about imminent 'fiscal cliff' tax increases." Not only were taxes raised for the wealthy, but due to the budget impasse, federal spending was cut through the sequester (automatic U.S. federal government spending cuts). Economic forecasters and other pundits were predicting that sequestration would hamper economic growth or possibly even cause a recession. *(Continued on Page 12)*

OUR 100TH EDITION

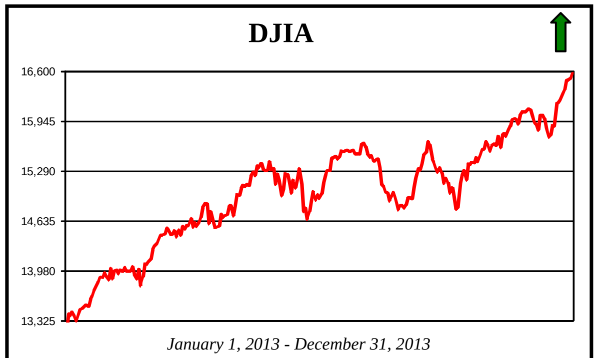
In this Issue

CAPITAL MARKETS SCOREBOARD

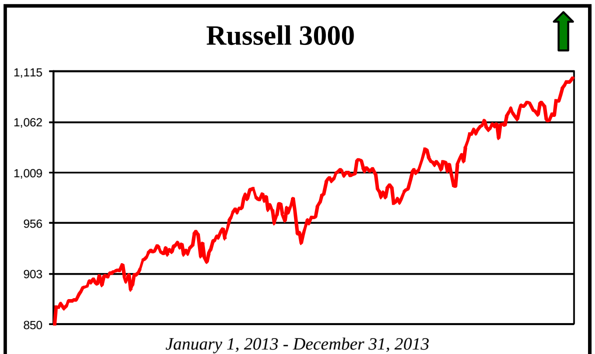
January 1, 2013 – December 31, 2013



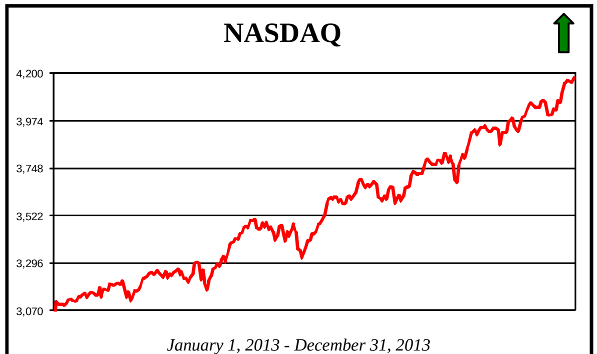
4th Qtr 10.51% YTD 32.39%



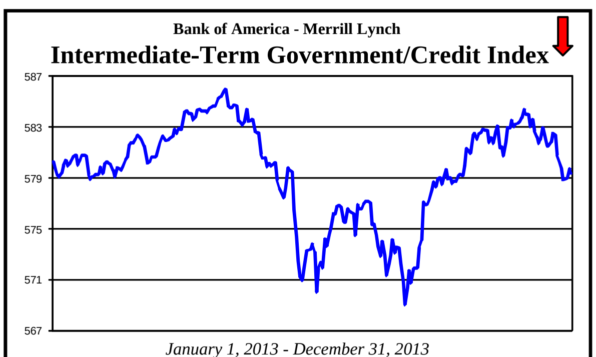
4th Qtr 9.56% YTD 26.50%



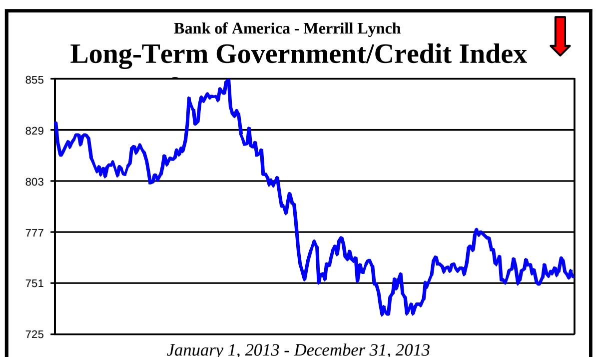
4th Qtr 9.56% YTD 30.95%



4th Qtr 10.74% YTD 38.32%



4th Qtr 0.07% YTD -0.16%



4th Qtr -0.69% YTD -9.43%

EQUITIES

EQUITY MARKET AND SECTOR PERFORMANCE

The Standard & Poor's 500 Index (S&P 500) posted a double digit return for the fourth quarter and delivered a total return of 32.4% in 2013, the highest yearly total return since 1997. International equities underperformed the S&P 500 for the year. The MSCI Emerging Markets Index fell 2.6% as concerns about the U.S. tapering resulted in capital flows out of these regions. Worries about emerging market demand for commodities, machine tools, and luxury goods weighed on the MSCI Europe Australasia Far East Index (EAFE), though it was still up 22.8%. According to Bloomberg, hedge funds returned 7.4% in 2013, marking their fifth straight year of underperformance relative to the S&P 500.

S&P 500 by GICS Sector	Total Return (%)	
	4Q13	**2013**
Consumer Discretion	10.8	43.1
Healthcare	10.1	41.5
Industrials	13.5	40.7
Financials	10.3	35.6
Technology	13.3	28.4
Staples	8.7	26.1
Materials	10.7	25.6
Energy	8.4	25.1
Utilities	2.8	13.2
Telecom	5.5	11.5
S&P 500 Index	10.5%	32.4%

The best performing sectors in the S&P 500 for the year were Consumer Discretion and Healthcare, despite lackluster job growth and uncertainty about the Affordable Care Act. Utilities and Telecom, even with double digit returns, were the worst performing sectors due to their high correlation to the bond market (long-term U.S. Treasury prices fell in 2013). The Financial sector outperformed the broad market as higher long-term interest rates steepened the yield curve and expanded bank margins. Higher home prices also helped banks carrying troubled real estate loans.

2013 also marked a year when lower quality stocks, those ranked B or below by Standard & Poor's equity rating service, outperformed higher quality stocks. For the year, low quality stocks were up nearly 11 percentage points more than high quality stocks, as investors became less concerned about economic growth and how it may financially impact lower graded companies.

> ***"The goal of long-run economic growth without asset price bubbles is not only achievable, but is something we should expect if we put a sound regulatory framework in place and if policymakers remain vigilant."***
>
> *~ Christina D. Romer, Ph.D.*

EQUITIES

PRICE MOMENTUM

After a banner year like 2013, investors often become more concerned that the stock market will perform in a negative manner in the coming year. The data to the right, compiled by Strategas Research Partners, shows that the S&P 500 has posted an average price increase of 6% following a year in which the index was up at least 25%. There is significant variation around the average, but the data shows that 2014 will not necessarily be a negative year for equities just because 2013 was a banner year.

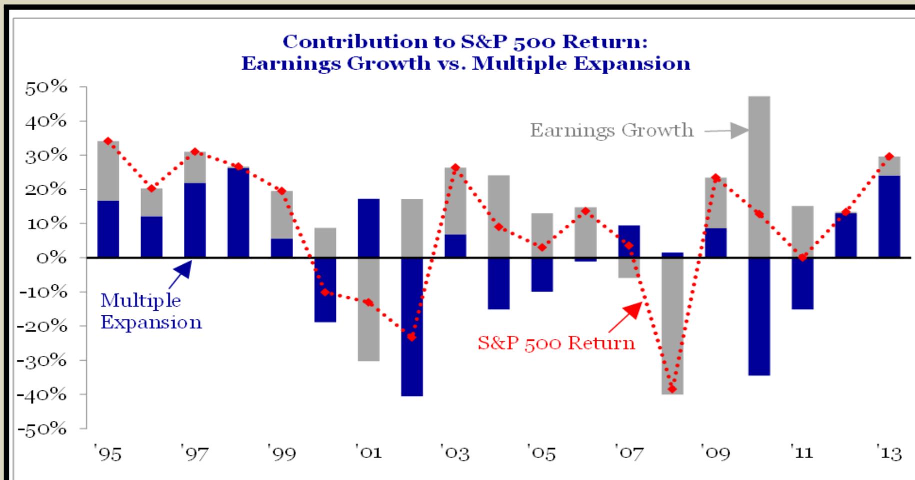
Years With S&P 500 Performance Greater Than 25%

Year	Price Return	Following Year's Return	Year	Price Return	Following Year's Return
1928	38%	-12%	1980	26%	-10%
1933	44%	-5%	1985	26%	15%
1935	41%	28%	1989	27%	-7%
1936	28%	-39%	1991	26%	4%
1945	31%	-12%	1995	34%	20%
1954	45%	26%	1997	31%	27%
1955	26%	3%	1998	27%	20%
1958	38%	8%	2003	26%	9%
1975	32%	19%	2013	30%	?
Average	32%	6%			

Source: Strategas Research Partners

EQUITY VALUATIONS

A significant upward move in equity prices can cause valuation measures like price-to-earnings (P/E) ratios to rise to an excessive level. This seems to be the situation as we enter 2014. When the final tally of fourth quarter 2013 earnings is made, earnings for S&P 500 companies are expected to have only grown by 4% in the aggregate, much less than stock prices advanced. Thus, more than 80% of the upward price move last year was driven by multiple expansion (what investors are willing to pay for a dollar of earnings). However, the data today indicates that P/E ratios, while higher, are not overly expensive. According to Strategas Research Partners, the last twelve months' earnings (LTM) for the S&P 500 show that the market is trading at 18.1x earnings. This compares with the longer-term average of 15.7x.



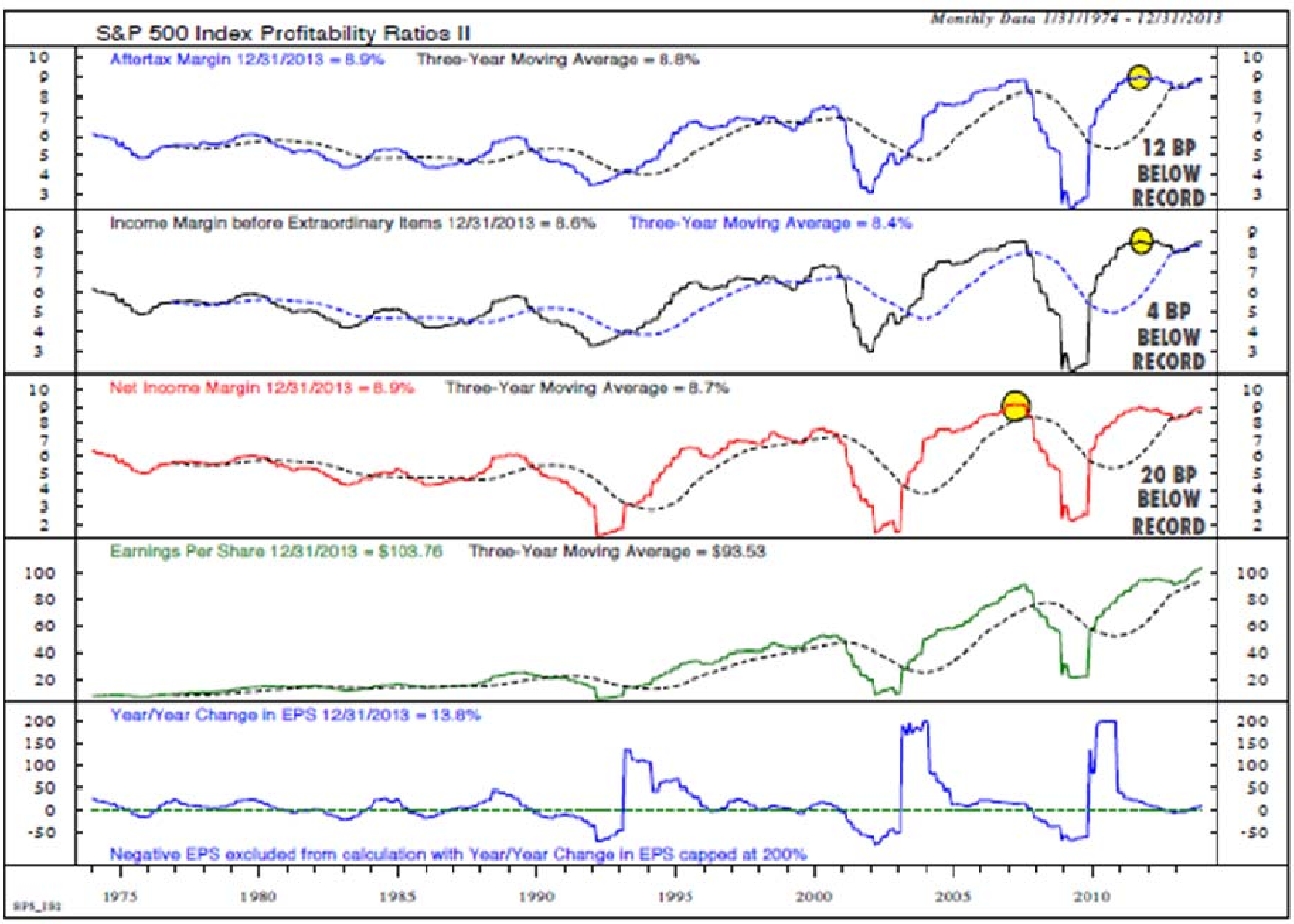
Source: Strategas Research Partners

The stock market is a forward-looking mechanism, though, so when looking at consensus earnings expectations for 2014, the market appears to be favorably valued. Based upon consensus 2014 earnings for the S&P 500, the index is currently trading at 15.4x 2014 expectations. This compares to a 15-year average of 16.0x forward earnings. Thus, a likely key for stock market performance in 2014 will be whether earnings meet or at least come close to current expectations. As opposed to the beginning of 2013, there is not as much room for error in 2014 due to higher valuation levels. Other valuation measures such as price-to-cash flow and price-to-book value support the posture that many strategists have taken; the S&P 500 closed 2013 at higher but reasonably valued levels.

EARNINGS AND REVENUE GROWTH

The bulls on Wall Street continue to point out that *earnings* are growing despite low *revenue* growth, and once revenue growth resumes, further earnings growth lies ahead. In previous economic cycles, revenue growth has been the principal driver of earnings growth for S&P 500 companies, but this cycle has been different thus far. In the face of anemic revenue growth, companies have been able to drive earnings-per-share (EPS) growth through cost-cutting and financial engineering. Examples of financial engineering include large share repurchase programs, which reduce the denominator of the EPS calculation, and refinancing high-cost debt with low-cost debt.

While both strategies are sources of value creation, revenue growth is clearly an important driver of shareholder value. Skeptics of the bull argument point out that for revenue to grow, companies must start hiring workers, which would lead to higher spending. However, this would cause costs to rise and thus mitigate the impact on earnings from higher revenue growth. Essentially, the skeptics are opining that productivity gains seen in recent years will wane, thus driving profit margins lower from near all-time highs. Bill Gross of PIMCO funds has indicated that profit margins in corporate America are now at bubble-like proportions. Some strategists view his opinion with caution, however, since PIMCO has a large stake at risk with their fixed income funds competing against equities. The bulls feel productivity gains will enable profit margins to remain at very high levels largely as a result of continuing advances in technology, which allow companies to produce more with fewer workers.



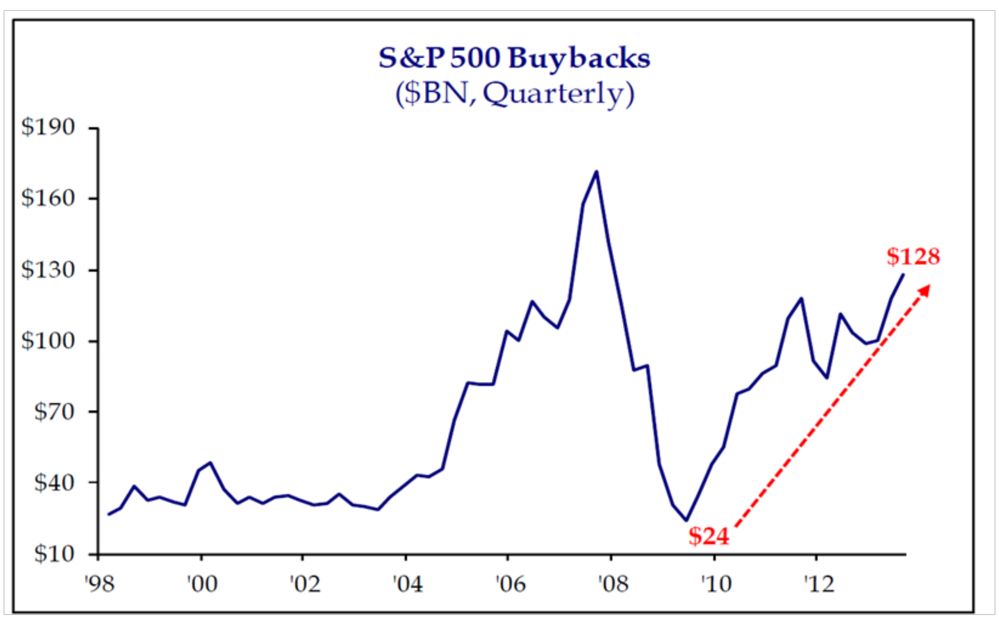
Source: Ned Davis Research

TECH STOCK EUPHORIA?

Many of the best performing stocks of 2013 were those levered to ‘new era’ technologies like social media, 3-Dimensional (3D) printing, and electric vehicles. After going public in November at $26/share, Twitter’s stock price more than doubled. With the increase in share price, Twitter's stock was valued at $35 billion on December 31st, which was 65x sales revenue, and the company was not yet profitable. Similarly, 3D Systems stock price more than doubled, and as the year closed was valued at $10 billion, 21x sales revenue and 74x 2014 earnings expectations. 3D Systems is a pioneer in 3D printing, parts, and services. Venture capital transactions are also assigning lofty valuations to social media darlings like Pinterest and Snapchat. Recent rounds of funding value both private companies in excess of $3 billion, though neither company has yet to make a profit. Pinterest reportedly has sales, but Snapchat has yet to detail how it will make money. While we are not yet back to the days of valuing internet companies based upon the number of eyeballs, or page clicks, current trends are worth monitoring.

CORPORATE FINANCE TRANSACTIONS

As mentioned earlier, corporations actively bought shares of their own companies in 2013. Corporate balance sheets are strong, and corporate cash as a percentage of assets is at a historically high level. Corporations choosing to return some of this cash to shareholders typically do so via a dividend payment or share repurchase. Approximately 60% more funds have been allocated to share buybacks than to dividends, even though dividend growth has been positive. The benefit of a buyback to shareholders is as shares are repurchased by a company, the total number of outstanding shares decline. Therefore, even if profits remain the same, the company’s earnings per share increases, which can benefit the valuation of the shares in the public market.



Source: Strategas Research Partners

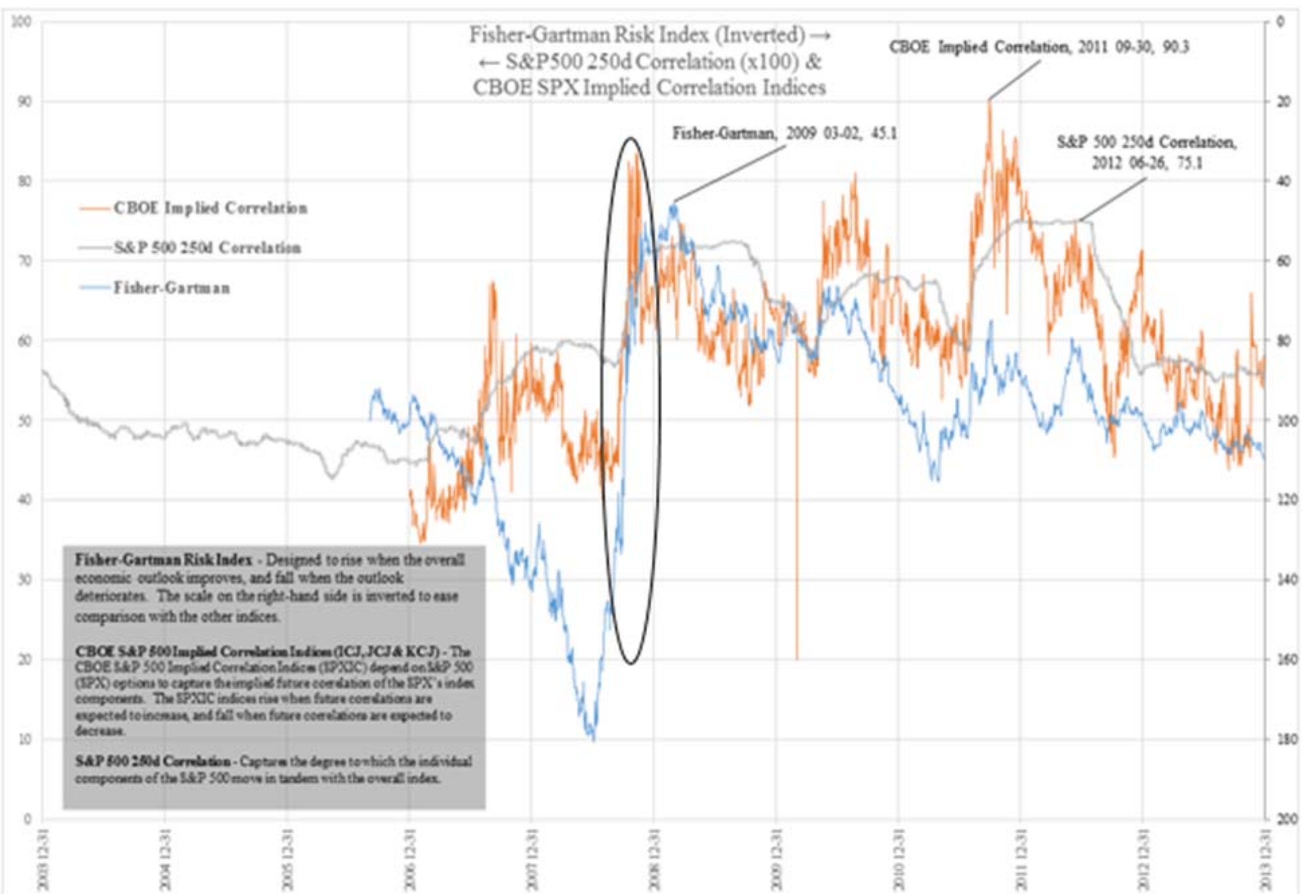
In addition to share buybacks, over 220 companies went public in 2013, raising approximately $56 billion, the most funding since 2007. Not since the financial crisis began has the stock market garnered more than 200 Initial Public Offerings (IPOs). The previous high for IPOs occurred during the final stages of the 2000 tech bubble when 406 companies went public, raising $97 billion. Estimates from Barclays show that companies may raise as much as $225 billion in equity capital through IPOs globally in 2014, with about $75 billion in the U.S. This compares to about $190 billion globally in 2013.

Merger and Acquisition (M&A) activity in 2013 was also fairly robust in the U.S. as annual volume increased 11% compared to 2012, according to Thomson Reuters. Companies from across the U.S. announced more than $1 trillion worth of deals during the year, the most since the financial crisis. The U.S. accounted for 43% of all deals worldwide, the biggest proportion since 2001. Global M&A deal volume was essentially flat, but volume improved throughout the second half of 2013, which bodes well for 2014. PricewaterhouseCoopers noted that the average monthly deal volume increased by 10% from 808 deals per month in the first six months of 2013 to 886 deals per month in the last six months.

EQUITIES

CORRELATIONS AMONGST EQUITY SHARES

In the aftermath of the worldwide financial crisis, prices of equity shares began to move in tandem with each other, irrespective of company fundamentals. The reason was clear: the vast majority of market participants believed the macroeconomic effects of the Great Recession overwhelmed individual company traits. The graph below illustrates the increased co-movement, or correlation, as measured by three different indices since the beginning of 2007. Note the outsized, rapid rise in the third quarter of 2008. More recently, though, the intra-index correlations have been decreasing. For instance, the Fisher-Gartman Index (blue line) has been declining since March 2, 2009. Similarly, the Chicago Board Options Exchange (CBOE) Implied Correlation measure (orange line) is sharply lower than its September 30, 2011 high. Even the late-peaking S&P 500 250d Correlation Index (gray line) is materially lower than its June 06, 2012 reading. All three measures are showing as macroeconomic risks recede, correlations among individual stocks continues to fall.



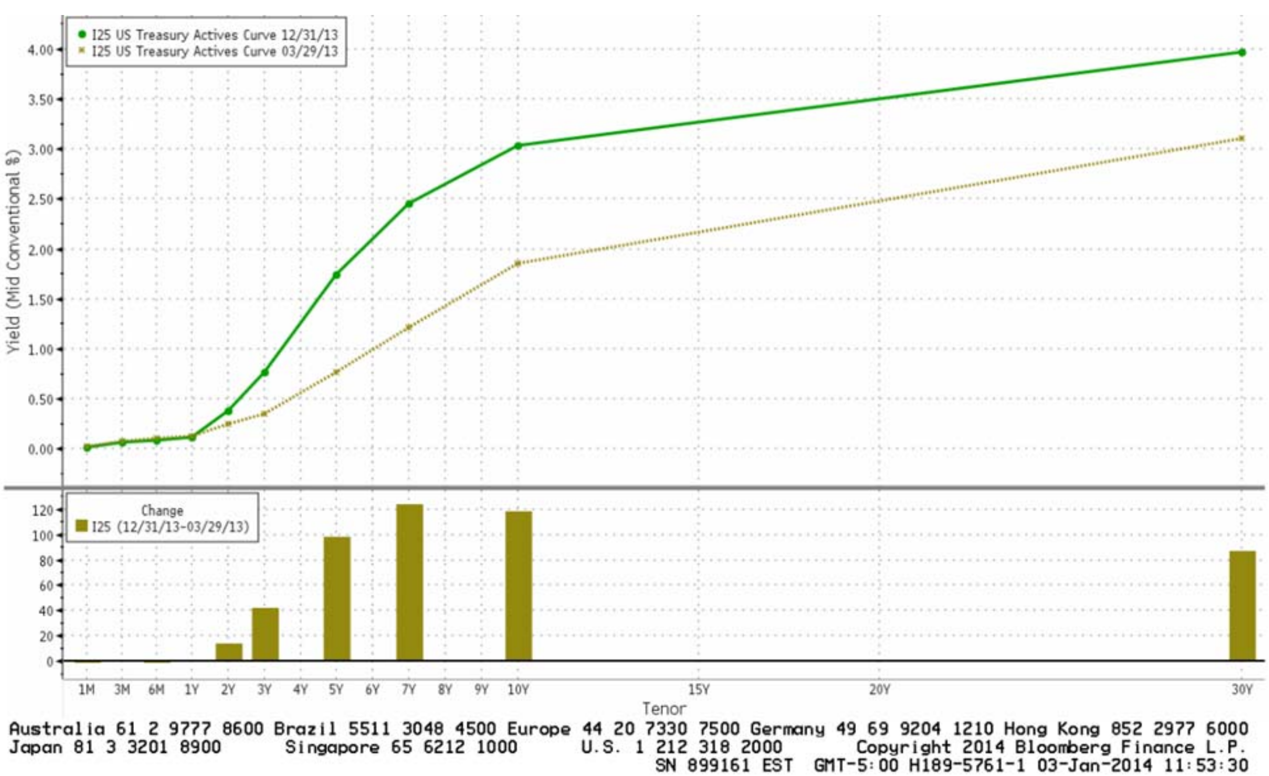
Source: Bloomberg Professional Service, Strategas Research Partners

FIXED INCOME MARKET PERFORMANCE

The Bank of America Merrill Lynch (BofA-ML) broad U.S. Corporate, Government, and Mortgage Index posted a return of -2.3% in 2013, its first decline since 1999. The 2013 performance was also the poorest since 1994, when the aggregate market index fell 2.8%. Other BofA-ML bond indices performed in a similar fashion as seen in the returns for the following indices: U.S. Treasury index, -3.4%; the municipal index, -2.9%; and the investment-grade corporate index, -1.5%. However, the high-yield corporate index was up 7.4% as investors continued to stretch for yield and expose themselves to more credit (individual company) risk. The BofA-ML Inflation Linked U.S. Treasury Index posted the worst return of the year by a large margin at -9.4%. Although the higher-quality fixed-coupon indices ended lower for the year, the majority of the declines occurred in the second quarter of 2013. The returns for the indices in the fourth quarter of 2013 were mixed and generally better than the full-year results. The bond indices which posted a fourth quarter decline were the broad market index, -0.2%; U.S. Treasury index, -0.9%; and the inflation-linked U.S. Treasury index, -2.2%. The bond indices which increased were the high-grade index, +1.0%; the high-yield index, +3.5%; and the municipal bond index, +0.4%.

THE STEEPENING YIELD CURVE

The yield curve describes the shape of a line connecting the points on a chart that plots a fixed income security's rate (yield) on the y-axis and its time to maturity on the x-axis. The yield curve for U.S. Treasury securities steepened from 160.5 basis points (bps) to 264.7bps between the end of the first quarter of 2013 and the end of the year. 100bps equals 1.0%. *(Continued on page 9)*

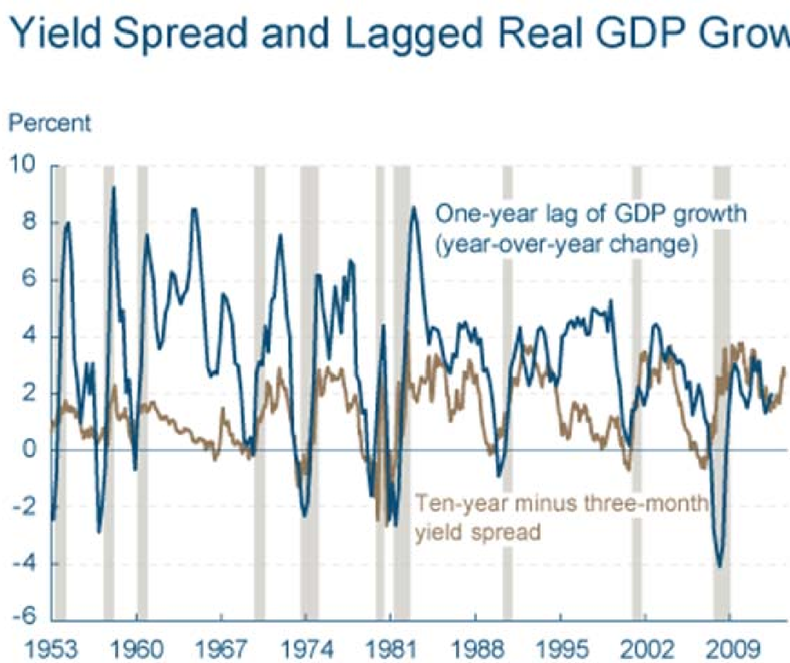


Source: Bloomberg Professional Service

THE STEEPENING YIELD CURVE

(Continued from page 8)

Many market participants have noted the steepening because of the yield curve's correlation to economic activity. More specifically, the slope of the yield curve has proven itself an efficacious *predictor* of economic recessions, and it is useful as an indicator of the strength of future economic growth. Indeed, according to the Federal Reserve Bank of New York, an inverted yield curve has correctly predicted every U.S. economic recession since 1950. Further, it only produced one false positive, when the curve inverted in 1966 prior to the 1967 credit crunch and production slowdown. The Federal Reserve Bank of Cleveland recently published an article entitled "The Yield Curve and Predicted GDP Growth," in which the authors conclude that "…a flat curve indicates weak growth, and…, a steep curve indicates strong growth." The authors highlight the strong relationship between the yield spread and future economic growth by plotting both variables on the same chart, but lagging the GDP data by one year.



Note: Shaded bars indicate recessions.
Sources: Bureau of Economic Analysis, Board of Governors of the Federal Reserve System.

Source: Cleveland Federal Reserve Bank

The difference between long-term rates and short-term rates is known as the "term spread" or "yield spread", which market participants tend to quote as the spread between U.S. Treasury bonds (USTs) maturing in two years (UST2s) and in ten years (UST10s; the 2s10s spread). On the other hand, academics and other researchers prefer the spread between UST10s and a derivative measure of the three-month UST bill's discount rate or the Federal Funds rate. In any case, the spread is calculated as the long-term rate *minus* the short-term rate.

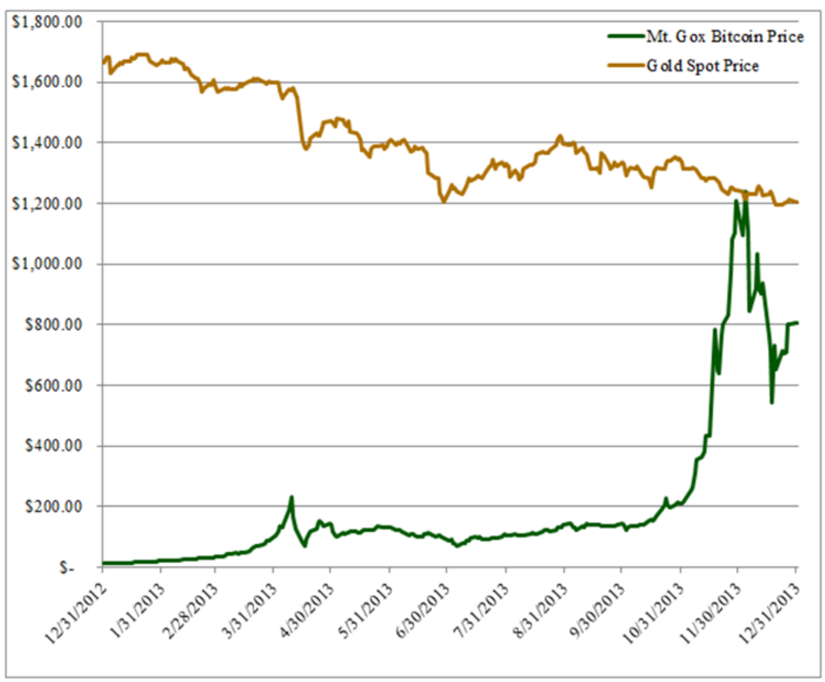
In general, a steepening yield curve is considered a positive indicator for stock markets because better economic growth allows companies to increase production, hire more employees, generate greater revenue and increase profits. On the other hand, a steepening yield curve is considered a negative for fixed-payment securities, such as bonds. Bonds do not benefit directly from the presumed economic improvements and profit increases, and their prices decline as the value of their future cash flows erode due to inflation. However, care must be taken to consider why a yield curve has steepened. For instance, if the spread expanded dramatically and quickly because of a flight-to-safety in short-term bonds, a steepening curve should not be expected to benefit equity shares. In addition, short-lived yield curve inversions, such as those lasting just a few days, have not historically predicted future recessions.

CHANGES AT THE FEDERAL RESERVE

On October 9th, President Barack Obama nominated Janet Louise Yellen to replace current U.S. Federal Reserve Chairman Ben Bernanke. Yellen will be the 15th chair of the Federal Reserve (Fed) and the first woman to occupy the position in its 100-year history. She is the daughter of a schoolteacher and a physician, served as a University of California at Berkeley economics professor from 1980 - 2006 and a Fed governor from 1994 - 1997. She was also the San Francisco Fed president from 2004 - 2010 and was previously the vice chair of the Federal Reserve Board since 2010. Yellen is married to George Akerlof, who won the Nobel Prize in economics in 2001. She has a son, Robert, who is an economics professor at the University of Warwick in England. One of Yellen's most pressing orders of business will be deciding how quickly to taper the Fed's $85 billion of monthly bond purchases. On December 18th, the Fed announced it would reduce its bond buying by $10 billion per month beginning in January 2014. Some financial pundits suggest the rate of tapering could (and should) accelerate. But if tapering spooks the equities market, there is some conjecture that the tapering could be halted, supported in part by the Fed's comment that purchases during this round of quantitative easing will be "open-ended."

VIRTUAL CURRENCY GAINING IN POPULARITY

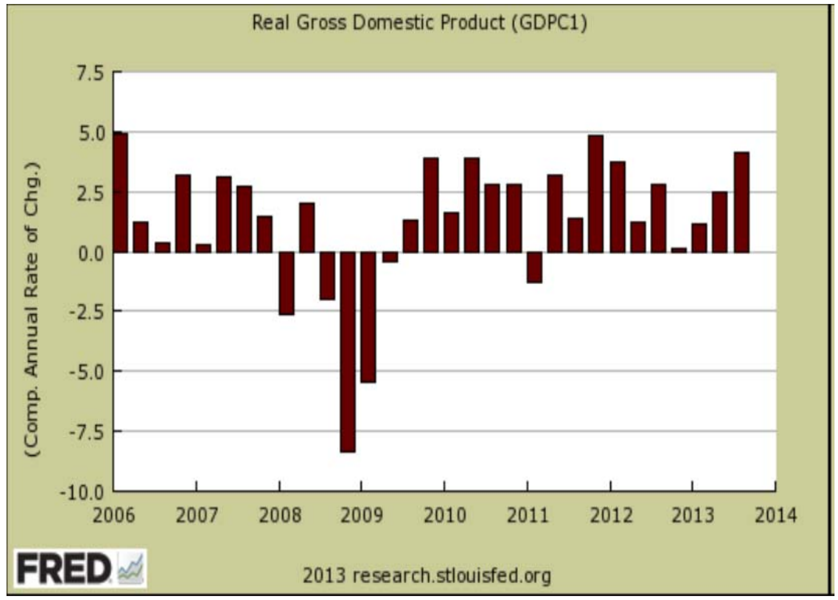
Bitcoin, a digital medium of exchange first introduced in 2009, burst onto center stage in 2013. The "crypto-currency" started the year at below $15 before skyrocketing to a peak over $1,200 on the Mt. Gox Bitcoin exchange toward the end of November. While an increasing amount of service providers and retailers have begun to accept bitcoins as payment, prices have swung wildly due to speculation, increasing regulation, and taxation, sometimes over $390 in one day. The price of bitcoins on the exchange surpassed the price of gold for just one day before making a sharp downward turn to close the year at just over $800. While Bitcoin and gold are similarly seen as protection and diversification away from central bank controlled fiat currencies, the two have had divergent paths in 2013 as frustration in gold gave way to confidence in the sustainability of Bitcoin. The price returns have been strong, but the feasibility of Bitcoin to become an accepted currency remains in doubt as many governments and central banks hesitate to rule on the taxation and legality of the crypto-currency. In December, Norway declared that it would not recognize Bitcoin as legal tender, will treat it as an asset, and impose a capital gain tax. Also, China's central bank banned financial institutions from dealing in the virtual currency, citing the risk of criminal activity. Ultimately Bitcoin's biggest strength, its ability to circumvent government control, may become its biggest weakness as central banks strive to maintain their grasp on the means of trade globally.



Source: BitcoinCharts.com, Bloomberg Professional Service

3RD QUARTER GDP REVISED UP

The third quarter increase in real GDP was revised up on December 20th to an annual rate of 4.1%. The increase primarily reflected: (1) an acceleration in private inventory investment, which accounted for 40% of the third quarter GDP increase; (2) a rise in personal consumption expenditures (PCE); (3) accelerated spending by state and local governments, partially offset by reduced federal government spending; and (4) a reduction in imports that was partially offset by reduced exports.



Source: Federal Reserve Bank of St. Louis

Private businesses increased inventories by $115.7 billion in the third quarter, which added 1.7 percentage points to the change in third quarter GDP. Such a large inventory accumulation in the third quarter likely led to a reduction of private inventories in the fourth quarter of 2013, resulting in slower GDP growth. The majority of the growth in PCE was due to purchases of goods. Services added only 0.3 percentage points to GDP growth in the third quarter, essentially all of which came from health care. Fixed investment in residential and nonresidential real estate accounted for 0.3 and 0.6 percentage points respectively of GDP growth in the third quarter. The contribution made by total residential investment in the third quarter, although positive, was still only half of the levels realized during the housing peak in 2005 and 2006.

GOVERNMENT SHUTDOWN AND BUDGET AGREEMENT

On October 1, 2013, the United States Government shut down operations deemed “non-essential” due to Congressional disagreement on continuing resolutions for federal funding. The impasse lasted 16 days and gave rise to fear among investors that the U.S. would default on its debt. It ended with a stopgap measure to fund normal operations through January 15, 2014 as well as suspend the debt ceiling until February 7, 2014. The deal eased automatic spending cuts in the future and set discretionary spending at $1.012 trillion in 2014 (roughly halfway between the Senate budget level of $1.058 trillion and the House budget level of $967 billion) and $1.014 trillion in 2015. Social Security, Medicare, and other programs labeled “mandatory” were not included in the budget. Hundreds of thousands of federal workers were furloughed during the 16-day shutdown. According to financial ratings agency Standard & Poor’s, the ordeal cost the U.S. economy an estimated $24 billion.

Later in December, Congress passed a 21-month (two year retroactive) bipartisan budget agreement in an effort to reduce the chance of a future shutdown, although the looming debt ceiling could cause another partisan standoff in early 2014. As a percentage of GDP, the federal deficit has fallen from more than 10% in 2011 to 4% in 2013 and less than 4% projected in 2014. Pre-recession, a deficit of 4% of GDP used to be considered as reckless, while now some consider it as austerity and a fiscal drag on the economy.

Each year, the House and Senate must agree on how to fund various entities within the federal government. If they cannot agree on how to do so, these entities must shut down. The core issue of disagreement during the most recent shutdown was funding healthcare legislation known as “Obamacare.” The only prior government shutdown that lasted for an extended period of time occurred in 1995 - 1996 due to disagreement over budget matters. Congress reached a resolution after 21 days.

COMMENTARY

2014: EXPECTATIONS HIGHER FROM ONE YEAR AGO

(Continued from page 1)

The fears had basis in fact, but proved to be surmountable as the results were anything but disastrous. While bond investors found the year to be difficult, equity investors were treated very well. As we enter 2014, expectations are generally higher, especially for the economy. This is largely due to the recovery in home prices and the stock market gains of the past few years. For investors, there are many key issues to monitor as the year progresses. What follows is a listing and associated commentary on the more relevant issues at this point in time. It is important to keep in mind, though, that there may be other events which are unforeseen that may ultimately prove to alter the investment landscape when we look back on the year at this time in 2015.

The Economy – The consumer, representing approximately 2/3 of the economy, clearly overcame the supposed "fiscal drag" of the sequester and the austerity measures of state and federal governments. Economic prognosticators had forecasted 2013 economic growth of less than 2.0%. The U.S. economy performed better than expected with annual real GDP growth expected to be 2.4% for 2013 when the final numbers for the fourth quarter are posted soon. The numbers suggest a stronger trajectory for the economy and consumer spending going into 2014.

Inflation – Views on inflation have been and continue to be widespread. Many investors are worried about the enormous amounts of liquidity pumped into a global financial system by central banks and the potential for hyperinflation. Others worry that deflation may be the problem going forward. The inflation rate in 2013 was 1.2%, less than the 2.0% number targeted by the Fed, the European Central Bank, and the Bank of Japan. The most obvious danger of "too-low" inflation is the risk of falling into outright deflation. As Japan's experience shows, deflation is damaging economically and hard to rectify. Central banks around the globe are, accordingly, as concerned with deflationary pressures as they are with inflationary ones.

Industrial Production – U.S. industrial production, which measures the output of manufacturers, utilities, and mines, hit a milestone in November 2013 when it surpassed the pre-recession peak of December 2007. It is now 21% above its trough of June 2009 and 3.2% ahead of one year ago. The manufacturing component of industrial production remains below its 2007 peak, but it has posted four consecutive monthly gains and is 2.9% ahead of one year ago. Utilities and mining are also ahead of levels one year ago, up 2.8% and 5.2% respectively.

The Fed & U.S. Monetary Policy – The U.S. Federal Reserve celebrated its 100th anniversary in 2013, and perhaps never in its history has it faced the complexity and risk than it does now. At the end of 2013, three rounds of QE have inflated the Fed balance sheet to $4 trillion, up from $800 billion before QE started in 2008. QE3 started in September 2012 and entailed purchasing $85 billion monthly of U.S. Treasury bonds and mortgage-backed securities. Annualized, that means more than $1 trillion a year of bond purchases that end up on the Fed's balance sheet. QE3 is not sustainable, and the Fed recently announced that it will start tapering in 2014 by reducing monthly bond purchases by $10 billion. Chairman Bernanke announced in May 2013 the possibility of reducing, or tapering, the amount of bond purchases but delayed any final decision until December 2013, his last major decision as his second four-year term ends in January 2014. From May to December, tapering, or lack thereof, was the most talked-about and analyzed event in 2013 and it will continue to be as long as QE3 exists. The Fed also will continue its accommodative monetary policy by keeping short-term interest rates close to zero even after unemployment rates fall below 6.5%, unless inflation exceeds 2.5%. Chairwoman Yellen is widely expected to continue Bernanke's monetary policies.

COMMENTARY

Congress & U.S. Fiscal Policy – While a flawed budget deal may be better than no budget deal, one of the flaws in the U.S. fiscal policy is that congressional voting on spending is separated from voting on borrowing via the debt ceiling. The debt ceiling law has been in effect since 1917, but was not a political issue until the 1970s. Since the Carter administration, Congress has voted 45 times to increase the debt ceiling. Linking the vote to borrow to the vote to spend would seem logical, but do not count on congressional rationality in this day of partisan politics. This will become headline news again in February 2014, when the federal debt is again expected to approach the debt ceiling of $16.7 trillion.

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The Volcker Rule – The Federal Reserve Act, passed in 1913, is a 31-page Act of Congress signed into law by President Woodrow Wilson. The Act created and set up the Federal Reserve System and granted it legal authority to issue Federal Reserve Notes (legal tender currency). The Dodd-Frank law, passed in 2010, was 2,391 pages long. It entails 398 rules, of which 161 have been finalized, and the Volcker Rule is the latest. From its conception to finalization by five government regulatory agencies, the Volcker Rule has grown to 963 pages, containing 2,826 footnotes and posing 1,347 questions. All this verbiage is to basically prevent proprietary trading by banks. They can still trade for clients, but most banks had already eliminated proprietary trading in anticipation of the rule. Full compliance is not required until July 2015. Monitoring and compliance will be complicated, and there may be unanticipated consequences such as less liquidity and more cost to trade less actively traded issues such as corporate bonds.

The Financial System – Yet to be fully resolved is the "too-big-to-fail" issue – the theory that certain financial institutions are so large and interconnected that their failure would be disastrous to the economy. The 10 largest financial institutions in the U.S. in 2013 had more than $11 trillion of assets, compared with $7.8 trillion at the end of 2006. The market share of those 10 institutions has also increased, and thus their added contribution to systemic risk – the risk that some catastrophic event would collapse the entire financial system. In 2013, thankfully, the U.S. financial system was much stronger and transparent than before the financial crisis. Dodd-Frank, Basel III, and other regulatory changes have taken debt and leverage out of the system and increased capital and monitoring not only of banks, but also non-bank financial institutions. Hopefully regulators now understand the true complexity and interconnectedness of the global financial system.

COMMENTARY

Corporate Profitability – Corporate profits relative to GDP remained at historically high levels in 2013: 11% versus a 66-year average of approximately 6%. While revenue growth in 2013 was subpar, corporations were able to grow earnings through cost controls and share buybacks. Because of economic and political uncertainty, corporate investment has not kept pace with profitability. Also, the capacity utilization rate is now slightly below 80%, so there is no urgent need for capital expenditures until utilization picks up another 5 or 6%. In spite of excess capacity and well-healed balance sheets, U.S. corporations set records in 2013 for issuing bonds, both investment grade and high yield, taking advantage of historically low interest rates.

Employment – Job growth averaged about 190,000 monthly in 2013. The unemployment rate was reported to be 7.0% as of December 31, 2013, down from 7.8% at the end of 2012 and a peak of 10.0% in October 2009. Not all of the improvement in the unemployment rate was due to job growth. The labor participation rate (based upon those employed or actively looking for employment) fell to a 30-year low of 63.0%, meaning millions of people have left the labor force for whatever reason. While a lower unemployment number can be a positive, it is important to note at the end of 2013 there were 1.2 million fewer people working in the U.S. than at the end of 2007.

Household Debt – Financially, households have put their houses in order, so to speak. They have paid down more than $1 trillion of debt since the financial crisis, mostly mortgage debt which comprises about 70% of household debt. The debt service ratio, debt payments as a percent of disposable income, also fell to a 30-year low in 2013 as it approached 10%. With household balance sheets in better shape and consumers more confident, U.S. household debt increased in 2013, the first annual increase since 2008. One area of debt that is of concern is student loans, as the amount outstanding surpassed $1 trillion in 2013. According to the Federal Reserve Bank of New York, of all loan types, student loans experienced the highest delinquency rates during 2013 at 12%.

Household Wealth – U.S. households lost $19 trillion in the financial crisis: $9 trillion in stocks, $7 trillion in housing, and $3 trillion in other assets. All of this did not happen simultaneously as stock prices started to increase in March 2009 while housing prices continued to drop through 2011. The peak loss was approximately $15.0 trillion. However, household net worth, the value of assets minus debt, set a record of $77.5 trillion in 2013. Adjusted for inflation, this amount is about the same as the $69 trillion of household net worth in 2007. Add in population growth and average household net worth is still below 2007 levels. Less debt, housing prices up 12% in 2013, and higher stock prices have contributed to the record levels of household net worth. Since 70% of household assets are financial in nature, interest rates and stock prices are the main drivers of household wealth. Many households are not able to participate in the financial markets, so the distribution of net worth is more unequal today than any time since the 1920s. The same is true of the distribution of income.

Energy – One of the major milestones in 2013 was that the U.S. became the world's largest producer of energy (oil and natural gas), surpassing Russia. This was mainly due to natural gas production, but oil production also has been ramping up. Because of horizontal drilling and fracking, the U.S. has the potential to become North American energy independent. According to *USA Today*, domestic oil production is at a 24-year high while foreign oil imports are at a 17-year low. The result: production exceeded net imports for the first time since February 1995. Lower energy costs have given the U.S. a competitive cost advantage over European and Asian manufacturers, and the U.S. has started to attract direct foreign investment to the U.S. because of cheaper energy. This cost advantage is expected to be sustainable for a decade or longer.

COMMENTARY

While many of the above issues reflect a positive trend, the reality is we may still be in a slow-growth economic recovery. Recessions caused by financial crises take longer to recover from than normal cyclical recessions because debt has to be taken out of the system. Many economists believe this process has been completed in the U.S. for the household and financial sectors as the year 2013 came to a close. Hopefully, this has set the foundation for continued economic growth in 2014 and beyond. The corporate, household, and financial sectors in the U.S. are all in better shape than any time in the last decade or longer. The European economies and financial systems appear to have stabilized, and Abenomics in Japan has produced positive economic growth and elevated the confidence of stock investors. China's economic growth has come down over the last five years, but still is expected to be a solid 7.5%. Global and U.S. economic growth expectations are higher as we move into 2014 than they were at the beginning of 2013, with U.S. economic growth this year expected to be around 2.5 - 3.0%. Should global economic growth meet current expectations, there is a high probability that equity investors will look back on 2014 in a positive manner, although probably not to the degree as with 2013. For investors in fixed income securities, many strategists believe the now higher level of interest rates has mitigated a sufficient amount of risk such that they expect investment grade bonds to provide positive returns, unlike 2013, but still fairly muted in nature.